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<p>THE EURO FIVE YEARS ON: ACHIEVEMENTS AND NEW CHALLENGES</p>
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DALLAS

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Ladies and Gentlemen,

It is a great pleasure for me to be here with you to talk about the European single currency. I am deeply honoured to have been invited by the Federal Reserve of Dallas and the University of Texas-Austin to share a few considerations on European affairs with such a great audience.

Both the preamble to the US Constitution and the draft Treaty establishing a Constitution for Europe aim at creating "a more perfect union" between countries, people and cultures. The EU countries were divided for a long time, and the European continent has only just reunified with the entry of ten Central and Eastern European countries into the European Union two weeks ago.

Even though it has 20 official languages, this Union created a common currency five years ago that was adopted by 12 countries. As a former member of the Executive Board of the ECB, and as current Governor of the Banque de France, I am pleased to present the **solid foundations** that underpinned the euro and made it a success story (**Parti**). The euro has been a **powerful driving force** towards economic and financial **integration**, emphasised today by its increasing **international role (Part 2)**. That said, going forward, the EU will have to face challenging issues such as **budgetary cohesion, structural reforms** and **European enlargement (Part 3)**. Those challenges must be seen as an opportunity to move forward. We are dedicated within European central

banks to doing our best to serve European interests and extremely optimistic about what lies ahead.

## PART 1/ THE EURO IS UNDERPINNED BY SOLID FOUNDATIONS

### A. The achievements of the single monetary policy

#### A.1. A modern institutional and operational framework

A. 1.1. The **independence** of the ECB fosters price stability:

- institutional, operational, financial independence;
- enshrined in the Treaty;
- vis-a-vis either the Community institutions or national governments.

A. 1.2. **Transparency** is also essential for gaining credibility ; ECB has gone beyond its requirements:

- the Governing Council specifies its quantitative definition of price stability, publishes reports on economic situation;
- is the 1<sup>st</sup> central bank to hold a press conference followed by **open discussion with journalists**.

A. 1.3. The Eurosystem is based on an **operational decentralisation**:

- it arises from the principle of subsidiarity, which underlies the entire European integration process;
- monetary policy decisions are taken in a centralised fashion, by the Governing Council of the ECB, but implemented by the national central banks.

A. 1.4. The Eurosystem benefits from an **efficient operational framework**:

- appropriate monetary policy instruments;
- procedures that guarantee a high level of security for payment systems (especially Target system).

#### A.2. The strategic framework

A.2.1. A precise definition of **the primary objective of price stability**:

- price stability is defined as an annual increase in the HICP **close to** but below 2% over the medium-term;
- in order to exclude situations of deflation and inflation differentials in the euro zone;
- difference with inflation targeting: inflation forecasts are only one component in the decision-making process.

A.2.2. A **"medium term" orientation**:

- the single monetary policy does not have a fixed horizon defined ex ante but is medium-term oriented;
- the two-pillar approach: cross-checking of the economic analysis for short-term determinants of inflation; and the monetary analysis of long-term determinants of inflation.

#### A.3. The achievements of the ECB monetary policy:

- credibility of the single monetary policy: in spite of adverse exogenous supply shocks leading to a rise in HICP above 2% from 2000 to 2002, **long-term inflation expectations anchored at around 1.8% to 1.9%** throughout this period;
- Most of monetary policy decisions were **correctly anticipated** by the markets;
- the euro returned to the levels at which it was introduced on the market in January 1999.

## B. The achievements of the monetary policy relies on the smooth functioning of multilateral surveillance procedures within EMU

### B.I. A framework of **multilateral surveillance** procedures:

- The implementation is entrusted to the Eurogroup or the Ecofin;
- All economic fields are concerned: labour market (Luxembourg process), product and capital market (Cardiff process), wage development (Cologne process), and fiscal policy (Stability and Growth Process);
- The whole process is coordinated under the Broad Economic Policy Guidelines recommendations, which encompass a medium-term assessment of the convergence of the economies / scrutinised annually, with SGP updates.

B.2. **Fiscal discipline** within a cooperative framework is the corollary to the single monetary policy:

- The SPG imposes the same fiscal discipline to all EU members;
- Member States are expected to consider their **economic policies as a matter of "common concern"**.
- Acceding countries will abide by the same rules

## PART 2/ THE EURO: A POWERFUL DRIVING FORCE TOWARDS MORE ECONOMIC AND FINANCIAL INTEGRATION AND AN INTERNATIONAL CURRENCY

### A. The pillars of an optimal currency area

#### A.I. **Sound macroeconomic fundamentals** define the Eurosystem:

- low level of inflation; resilience of the banking and financial system; quality of the labour force and the infrastructure;
- consequence: almost **EUR 112bn of FDI** compared with EUR 82bn in the US.

#### A.2. **A growing economic homogeneity** favours monetary policy transmission:

- Increasing correlation between national and euro area business cycles;
- Inflation dispersion in the euro area not much higher than in the US (whereas the latter benefits from a unifying federal budget);
- Rising homogeneity of responses of Member States to monetary policy impulses.

#### A.3. The changeover to the euro acted as **a catalyst for financial integration**:

- euro money market: the process is almost complete (price differentials in interbank markets under 5 basis points) ; it is under way on European bond markets, as well as on derivatives markets (strong development of Eurex);
- EU financial architecture frames up: implementation of FSAP (2000); and of the Lamfalussy process in the field of financial regulation and supervision.

## B. The euro successfully became an international currency and a nominal anchor

### B.I. Developments in **the private use of the euro**

#### B. 1.1. As a financial instrument, the euro took off immediately:

- In 2003, 60% of net issuance of international debt securities in euro, bolstered by EU companies and households;

#### B.I.2. A **significant intermediary in exchanges:**

- 25% of foreign exchange transactions (1/2 US dollar's share), more than the sum of shares of the European legacy currencies;
- A growing pricing role in trading activities: in euro area, 50%-60% of international trade outside the zone was denominated in euro, as well as in Central and Eastern Europe;

### B.2. **The growing official role** of the euro

#### B.2.1. Euro is the 2<sup>nd</sup> reserve currency after USD (18.7% in 2002 after 12.6% in 1999 of currency reserves):

- A factor of diversification of currency reserves against fluctuations;
- A trend bound to get momentum as major Asian central banks want to better balance their assets between USD and the euro.

#### B.2.2. **An anchor** for a number of exchange rate regimes: euro is used as a monetary benchmark (sole anchor or currency baskets) in 51 countries, with strong ties or institutional arrangements with the EU;

## **PART 3/ CHALLENGES OF THE SINGLE CURRENCY**

### A. Strengthening budgetary cohesion and co-ordination in the Union

- In line with the concept of **structural balances**, EU Member States should respect their commitment to achieve over the business cycle a budgetary position that is "close to balance or in surplus";
- Incentives should be devised to strengthen **sound fiscal policy in good times** to get margins for the rainy days.

### B. Structural reforms are needed in several areas

#### B. 1. A knowledge-based economy: the 2000 **Lisbon strategy**...

- ...emphasises the role of research, innovation and the diffusion of new technologies;
- ...aims at greater labour flexibility in order to increase productivity and a high level of employment.

#### B.2. **Corporate attractiveness** : developing "agglomeration dynamics"

- Euro area benefits from its high purchasing power...
- ...but progress is required as regards controlling production costs (labour costs).

#### B.3. **Goods and services market integration:**

- Reforms needed to remove entry barriers and promote complete integration;
- Especially in the services, but also in the energy and transport sectors and postal services.

## C. Some challenges of enlargement

### C.1. Institutional challenges:

- Concerning Eurosystem decision-making process: voting procedures have already been amended;
- But the implementation of the whole EU institutional framework is still a challenge, especially concerning:

Anti money-laundering procedures;  
Upgrading of banking supervision.

### C.2. Sustainable convergence:

- Real convergence must be achieved, in spite of the development gap:
  - Accessing countries : only 44% of total GDP euro area;
  - Catching-up process: 25 years under the hypothesis of a 1.5% growth differential.
- But it has to be **compatible with nominal convergence**, i.e:

The disinflation must continue (inflation rates are twice as high as in the euro area);

Fiscal position (average public deficit at 4.9% in 2002) and external deficit (3.7%GDP) must be contained;

Competitiveness must be preserved.

### C.3. The convergence process: ERM II is a "training room" more than a "waiting room".

- A pragmatic approach: a successful participation to ERM II is essential to achieve exchange rate stability, decided on a case by case approach, in order to prevent the excessive volatility in exchange rates;
- A flexible approach: to enhance economic cohesion, the mechanism envisages the possibility of realignments during the period of participation;

## CONCLUDING REMARKS

To conclude, let me emphasise that five years after its adoption, the euro has lived up to most, if not all, of our expectations. After the unprecedented and successful challenge of a continent-wide cash changeover, the euro almost instantly replaced the legacy currencies without any disruptions. It has fostered stability through its credibility and has shielded many euro area countries from significant exchange rate volatility and financial market turmoil. It is all the more important to acknowledge these achievements since it was said in some quarters that the euro would never "happen" or that it would create severe economic disruption. Those scenarios have not materialised.

In the post-war European adventure, the euro represents a major milestone. That said, and whatever its own merits, a currency is not an end in itself, even though the new EU members are keen on adopting it as soon as possible. Entry into the Monetary Union must be founded on a sustainable convergence process. Enlargement of the euro area indeed gives renewed impetus to addressing the challenges ahead as it makes it more pressing for policy-makers to tackle long-ignored weaknesses. This is a crucial contribution to building a stronger EU in which I strongly believe.

All in all, let me express my confidence in the future of the euro, which, five years after its birth, is the outstanding symbol of European identity and strength.